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SUBJECT: HISTORICAL IMF PACKAGE IMMINENT, MAY NOT BE ENOUGH

REF: KYIV 2138

Classified By: AMBASSADOR WILLIAM B. TAYLOR, REASONS 1.4(B) AND (D)

¶1. (C) Summary. IMF chief envoy Ceyla Pazarbasioglu told the Ambassador on October 25 that Ukraine,s IMF package may amount to the second largest ever in IMF history and would be likely finalized soon, possibly as early as this weekend. She stated that implementation of the assistance package would be conditioned on Ukraine,s fractious government coming to terms on anti-crisis legislation. She predicted her mission would wrap up by October 29, and that the IMF,s Executive Board could vote for approval as soon as the week of November 3. She emphasized that the IMF package alone will not equip the GOU for needed reforms, restore investor confidence, or loosen capital flows. Her team requested U.S. assistance in reaching out to other governments, foreign and domestic banks, private corporations, and the World Bank as a necessary supplement to the IMF deal. End Summary.

Funding Scope and Timeline

¶2. (C) Pazarbasioglu was unable to comment on an exact figure, but she said Ukraine,s assistance package would be the IMF,s second largest and the &quickest8 fund in history. The IMF,s Executive Board is prepared to take an immediate vote and, according to Pazarbasioglu, would undoubtedly be satisfied that the deal is within the IMF delegation,s pre-approved mandate. The size of the package, Pazarbasioglu pointed out, would not &shock the markets8 or restore investor confidence on its own. Any deal needed to be coupled with a unified message from Ukraine,s politicians and have concomitant support from the private sector, domestic and foreign banks, and foreign governments.

¶3. (C) The IMF team was prepared to conclude its negotiations on October 25, pending an agreement on terms with President Yushchenko, PM Tymoshenko, Minister of Finance Pynzenyk, and National Bank of Ukraine (NBU) Governor Stelmakh. Just as in previous IMF negotiations with Brazil and Turkey, the delegation will also request a separate letter from opposition leader Viktor Yanukovich, pledging the support of his Party of Regions in the event of a change in government.

¶4. (C) Pazarbasioglu will remain in Kyiv until October 29 or 30, long enough to ensure that the Rada will pass anti-crisis legislation consistent with the IMF package. The IMF Executive Board,s decision could come as soon as the week of November 3, according to Pazarbasioglu, though she was uncertain whether the Board had yet set a firm date for its meeting.

Conditionalities and Political Risk

¶15. (C) Pazarbasioglu stressed that implementation and disbursement of an IMF package hinges on anti-crisis legislation that has been proposed in the Rada but is still seemingly far from approval (reftel). Pazarbasioglu described IMF assistance as &useless unless attached to measures propping up the banking sector and ensuring a balanced budget. After the IMF reaches agreement with Ukraine's five signatories (see paragraph 3), and after the IMF Executive Board approves the agreement and the Rada passes anti-crisis legislation, an initial disbursement) up to one-third of the total package) could be made almost immediately. A second tranche would be linked to a balanced budget, and a third would be released at a later unspecified date.

¶16. (C) A prudent fiscal stance and a balanced budget are both vital, Pazarbasioglu stated, since Ukraine,s government has to take &measures to give confidence to the markets. The IMF package will not attach specific conditions on fiscal policy beyond a "balanced budget" (see paragraph 7), except to ask the government for a two-year suspension on a policy that links the minimum wage with a subsistence minimum.

¶17. (C) Pazarbasioglu stated that Rada legislation should treat the banking crisis in three important ways: it should have a mechanism for thorough diagnosis and rating of individual banks; a bank recapitalization program for troubled but solvent institutions; and a bolstered deposit insurance fund for clients of the weakest banks that may inevitably fail. Technical adjustments to the NBU,s authority would also be needed, so that the NBU would be certain to make good use of the available monies. She said that bank recapitalization funding could cause up to a 1.5 percent budget deficit, though this program would be seen by the IMF as a permissible exception to its conditions for a balanced budget.

¶18. (C) IMF conditionalities will require a flexible exchange rate to partially offset the huge terms-of-trade shock befalling Ukraine, caused by a collapse in steel prices and anticipated cost increases for imported Russian gas in 2009. Pazarbasioglu expects the NBU to move to a flexible rate policy, though she believes the NBU needs &hand holding on exchange rate liberalization, as it lacks both technical expertise and political backing.

¶19. (C) PM Tymoshenko was characterized by Pazarbasioglu as being "on board," while President Yushchenko &almost understands the gravity of the situation but is being "pulled the other way by confidants.8 She admitted candidly that Ukraine,s internal party deliberations and constraints were &tough (for the delegation) because the IMF is not a political entity."

¶10. (C) The Ambassador gave a readout from meetings with Yanukovych deputies who have been unreceptive to IMF intervention. Without specifically naming Yanukovych Chief of Staff Serhiy Liovochkin, with whom the Ambassador met on October 24, Regions, leaders were described as being opposed to fiscal belt tightening and a free floating exchange rate. The Ambassador mentioned that the Yanukovych,s camp believed Ukraine,s economic troubles could be managed with the NBU,s \$34 billion remaining reserves, and that the IMF package should not be counted on for disbursement until May. In fact, according to Liovochkin, the IMF, the U.S., and all the major financial institutions were at fault for Ukraine,s economic woes. Pazarbasioglu and the Ambassador agreed that Liovochkin,s point of view was not reflective of the urgent need to assist banks and restore confidence in Ukraine,s markets. Rather, it was indicative of Regions, political stance prior to possible Rada elections.

¶11. (C) Pazarbasioglu told the Ambassador that their meeting on October 25 was her first discussion outside a tight group of Ukrainian interlocutors. She had held talks with President Yushchenko (3 times) and PM Tymoshenko (2 times) and interacted daily with National Bank of Ukraine Governor Stelmakh and Minister of Finance Pynzenyk. She also has met with Minister of Economy Danylyshyn, Minister of Energy Prodan, and top executives at Naftohaz, the state energy company. Her deputies have had full access to the National Bank's records, and she characterized Naftohaz,s transparency as &day and night8 compared to early IMF,s fears about possible veils of information secrecy. The NBU was described as "very cooperative, very worried,8 though Pazarbasioglu added that she herself is also &very worried8 about the central bank whose top layer is solid but underneath is weak technically.

¶12. (C) Pazarbasioglu requested the Embassy,s assistance in cultivating private sector support for Ukraine,s economy, since the Fund,s program will not contain investor fear or capital flight on its own. The IMF plans to convene two separate roundtables early next week: one with bankers, foreign and domestic; the other with business and industrial leaders. The goal is for the IMF to brief banking and industry leaders on the assistance package, as well as solicit a general message of support from the two groups. Pazarbasioglu mentioned the possibility of a road show with major rating agencies and investment banks, likely to be held in London and New York in November. (Note: IMF resident representative in Kyiv informed Embassy late on October 25 that Rada Speaker Yatsenyuk will sponsor similar roundtables for IMF briefings on either October 26 or 27. If the IMF determines Yatsenyuk,s attendees are satisfactory, it may cancel plans to hold its own roundtables. End Note.)

¶13. (C) Separately, the Ambassador gathered G-7 plus EU ambassadors in Kyiv on October 24. They pledged to coordinate a G-7 plus EU meeting with the President, followed by meetings with the Prime Minister and opposition leader Yanukovych, calling on Ukraine,s leaders to jointly come to a resolution to the dual economic and political crises.

¶14. (C) The IMF envoy also expressed a keen interest to meet with U.S. Treasury officials in Kyiv, in order to discuss ways to bolster technical assistance in the banking and financial sector. She felt that the NBU urgently needed resources and technical collaboration.

¶15. (C) Pazarbasioglu asked for USG intervention with World Bank (WB) headquarters to approve a Development Policy Loan (DPL3). The WB,s funding, presently contingent on a public procurement law still pending in the Rada, would greatly help relieve pressures on the supply side in Ukraine,s economy, as well as complement the IMF,s demand side actions.

¶16. (C) The Ambassador met later on October 25 with WB resident representative Martin Raiser, who indicated that the WB was prepared to approve a \$500 million DBL3 loan by the end of 2008. The WB was standing firm on principle, he said, and saw the public procurement law as a necessary anti-corruption measure. Raiser suggested a draft law in the Rada was ready for approval but opposed by vested interests, particularly deputies in Tymoshenko's BYuT faction.

Comment

¶17. (C) Pazarbasioglu,s clear message was that the IMF package, while precedent setting, will nonetheless fall short of achieving the Fund,s ultimate goal of propping up Ukraine,s faltering economy. Only a concerted effort by all parties with a stake in the country,s stability will stave off a further unraveling. Pazarbasioglu believes the IMF should convene key private sector actors while still on the ground in Ukraine, but it has turned to the U.S. to help

generate sufficient World Bank support and provide needed technical expertise. End Comment.

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